In the

United States Circuit Court of Appeals

For the Ninth Circuit

No. 10386

PACIFIC POWER & LIGHT COMPANY

AND

AMERICAN POWER & LIGHT COMPANY,

Petitioners,

vs.

FEDERAL POWER COMMISSION,

Respondent.

PETITIONERS' BRIEF ON REVIEW

JOHN A. LAING,
HENRY S. GRAY,
Public Service Building,
Portland, Oregon.

*Attorneys for Petitioner,
Pacific Power & Light Company.*

A. J. G. PRIEST,
Two Rector Street,
New York, New York.

ADRIAN L. FOLEY,
14 Wall Street,
New York, New York.

*Attorneys for Petitioner,
American Power & Light Company.*

LAING, GRAY & SMITH,
Portland, Oregon.

REID & PRIEST,
WHITE & CASE,
New York, New York.
Of Counsel.

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PETITIONERS' BRIEF ON REVIEW

Introductory Statement

(a) Nature of Case—Jurisdiction of Court

This review involves the validity of Paragraphs (B) and (H) of an order of the Federal Power Commission dated November 24, 1942, which direct Pacific Power & Light Company to "dispose of" two amounts aggregating $6,863,573.07, theretofore and now recorded on its books of account as part of the company's assets (R. 61-2). An amount of $4,121,981.41 is ordered to be "disposed of" immediately, by charging $1,135,113.91 to a special reserve created pursuant to a prior order of said Commission in another proceeding, and by charging $2,986,867.50 to Earned Surplus, with permission to charge all or any part of the latter sum against a "Capital Surplus properly created for that purpose" (Paragraph B); and an amount of $2,741,591.66 is ordered to be disposed of by charges to income in ten equal annual charges, beginning with the year 1942 (Paragraph H).

Petition for Review was filed herein pursuant to Section 313 of the Federal Power Act (16 U. S. C. A. § 825*l*). Pacific Power & Light Company and American Power & Light Company, the Petitioners, being aggrieved by the above provisions of said Order (R. 61-64), entered in said Commission's proceeding designated "In the Matter of Pacific Power & Light Company—Docket No. IT-5611", filed their Petition to obtain a judicial review of said provisions and the setting aside and annulment thereof.

Prior to the filing of the Petition for Review and within thirty days after the issuance of the Commission's Order, Pacific* and American, the latter an intervener in the proceeding, filed separate applications for a rehearing before the Commission (R. 64-71, 71-79); and both of said applications were denied by order of the Commission, dated January 13, 1943 (R. 80). Within sixty days thereafter (R. 110), said Petition for Review was filed in this, the Circuit Court of Appeals for the Ninth Judicial Circuit, in which Circuit are located Pacific's operations and properties involved in said proceeding, and its principal place of business for the conduct of said operations (R. 92, 99).

(b) Parts of Order Under Review

Petitioners designated in their said Petition for Review, as the parts of said Order by which Petitioners deemed themselves aggrieved and in respect of which review herein was sought, Paragraphs (A), (B), and (H) thereof, and Paragraph (O) as applied to said Paragraphs (A), (B), and (H). Petitioners have since concluded to withdraw their objections to Paragraph (A) of said Order, and Pacific has complied with the requirements of said paragraph by recording in its books of account the amount of $4,121,981.41 in Account 107, Elec-

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* Hereinafter for brevity, the following expressions will be used: "Pacific" for Pacific Power & Light Company; "American" for American Power & Light Company; the "Commission" for Federal Power Commission; the "Act" for the Federal Power Act, 16 U. S. C. A. §§ 791 et seq.; and the "Order" for the Commission's Order of November 24, 1942.

tric Plant Adjustments, as directed by said Paragraph (A). No issue, therefore, is presented to the Court herein concerning the validity of said Paragraph (A).

With this elimination, the parts of said Order in respect of which judicial review is sought herein are Paragraphs (B) and (H), and Paragraph (O) as applied to said Paragraphs (B) and (H), namely:

> "(B) Pacific dispose of the amount of $4,121,981.41 established in Account 107, Electric Plant Adjustments, under Paragraph (A) above, by charging $1,135,113.91 of that amount to the special reserve created pursuant to the Commission's Opinion No. 69; and by charging the balance of $2,986,867.50 to Account 271, Earned Surplus; provided, however, that Pacific may charge all or any part of said $2,986,867.50 against a Capital Surplus properly created for that purpose.
>
> * * * * * * *
>
> "(H) Pacific dispose of the amount of $2,741,591.66 classified in Account 100.5, Electric Plant Acquisition Adjustments, by charging said amount to Account 537, Miscellaneous Amortization, in ten equal annual charges, commencing with the calendar year 1942;
>
> * * * * * * *
>
> "(O) Pacific file with the Commission on or before December 31, 1942, certified copies of the entries required by Paragraphs (A) to (N), inclusive, of this order; and on or before March 15 of each year thereafter the entries required by Paragraph (H) of this order until the entire amount in Account 100.5 has been disposed of;"

Pacific has now complied with all the requirements of said Paragraph (O) except those pertaining to said Paragraphs (B) and (H); and this Court, by order entered herein on March 18, 1943, pursuant to stipulation between the Commission and Petitioners, has stayed the requirements of Paragraphs (B) and (H), and of Paragraph (O) as applied to Paragraphs (B) and (H), during the pendency of this review, and, in the event that said Paragraphs (B) and (H) shall not have been wholly set aside

by the judgment or decree of the Court upon this review, until ten days after the issuance and service upon Pacific of certified copy of such judgment or decree, subject to the following conditions:

> "Provided, however, that during the period of the stay granted hereby, said Pacific Power & Light Company shall not declare or pay any dividends upon any shares of its common stock, or make any other distribution upon any shares of its common stock, except such dividends or distributions as might lawfully be declared, paid or made after complying with the provisions of Paragraphs (B) and (H) of said Order of said Commission, dated November 24, 1942" (R. 111-112).

(c) Description of Parties

Pacific is engaged in the public utility business in the states of Oregon and Washington, and has been so engaged since the month of July, 1910. Its properties are made up of both electric and non-electric facilities, and its electric facilities include certain transmission lines extending across the boundary line between the two states. As the owner of such transmission facilities, Pacific is a "public utility" as defined in Section 201 of the Act (16 U. S. C. A. § 824), and is therefore subject to the jurisdiction of the Commission to the extent provided by the Act. Pacific is subject to comprehensive regulation as a public utility or public service company by the states of Oregon and Washington, respectively, as to utility rates, adequacy of service, accounting, issuance of securities, contracts with affiliated interests, and every other important aspect of its business that concerns the general public. As a subsidiary of a registered public utility holding company (American), Pacific is also subject to the jurisdiction of the Securities and Exchange Commission to the extent provided by the Public Utility Holding Company Act of 1935 (15 U. S. C. A. §§ 79, et seq.).

American is a public utility holding company, registered as such under the Public Utility Holding Company Act of 1935. It owns 1,000,000 shares of the no-par value

common stock of Pacific, having a stated value on the books of Pacific of $7.00 per share, being all of said common stock issued and outstanding. American acquired said common stock as the result of certain transactions between American and Pacific in the years 1910, 1915, and 1930, whereby American caused to be transferred to Pacific certain properties, securities, and cash, receiving in return therefor securities issued by Pacific, which included certain bonds and certain shares of preferred stock of Pacific, which were sold by American to the public as contemplated at the time American received such securities, and various issues of common stock, which were converted into said 1,000,000 shares of no-par value common stock as a part of Pacific's 1930 transactions with American and Pacific's refinancing at that time. American was permitted to intervene in the proceeding before the Commission by order dated September 16, 1941 (R. 10-11), and actively participated in the hearing therein.

The Commission is the administrative agency entrusted with the administration of the Act. It is authorized by the Act, *inter alia,* to investigate and ascertain the actual legitimate cost of the property of public utilities and the fair value of such property, and to require that every public utility file a statement of the original cost of its property (Section 208; 16 U. S. C. A. § 824g), and to prescribe a uniform system of accounts to be kept by licensees and public utilities (Section 301(a); 16 U. S. C. A. § 825(a)).

Regulation of public utilities by the states in which Pacific conducts its business is vested as follows: by the State of Oregon, in the Public Utilities Commissioner of Oregon; and by the State of Washington, in the Department of Public Service of Washington. By orders of the Commission dated August 9, 1941, and September 26, 1941, these state regulatory agencies were permitted to intervene in the proceeding in which the Order was entered (R. 14-16), but neither of these agencies took an active part in the hearing in said proceeding, or offered any testimony at such hearing.

(d) Development of Pacific's Properties

During the early part of 1910 American, with keen vision and with faith in the then present and prospective efficiency and soundness of long distance transmission of electric power as a means of integrating scattered facilities for the economical development and distribution of electric power, began an investigation of the possibilities of creating a great power system in the Columbia River District of Oregon and Washington, which not only would take care of the then existing needs for power, but which would provide an adequate and dependable source of supply for existing and prospective power business in the territory (R. 182-5).

Because of the rugged terrain, the most productive part of the territory was then and is now located in very rich but narrow valleys, widely separated from the standpoint of economical long distance transmission of electric power at that time. Located in these valleys were many small communities served by local steam and small hydro-electric generating and distribution systems, which, in general, had developed from makeshift beginnings in connection with sawmills, flourmills and other enterprises of a similar nature, which were valuable going concerns in 1910, but were not, generally speaking, efficiently equipped with adequate generating and distributing facilities, from the standpoint of the art as then developed (R. Vol. III, Ex. 15, pp. 9, 10, 24-58).

This territory therefore offered an extraordinary opportunity for development and expansion through unified operation and the use of improved generating and transmission methods, particularly as valuable water power sites were available. The economical and adequate development of water power sites requires the expenditure of large sums of money in order to provide facilities capable of supplying electricity to meet present and anticipated needs in any given territory, and requires the sacrifice of an adequate rate of return on such capital during the inevitable development period. The his-

tory of the vicissitudes of the various attempts to supply the respective communities with adequate and cheap power described in Exhibit 15, pages 1 to 119 (R. Vol. III) testifies eloquently to the inability of local capital to meet the problems.

The four systems acquired by Pacific in 1910, namely, the Yakima-Pasco System, the Walla Walla-Pendleton System, The Dalles System and the Astoria System, the units of which had previously been gathered together by American, served only seventeen communities; had an installed capacity of 11,875 kw; had 388 miles of pole line; served 7,356 customers, and had gross annual electric earnings of $592,781 (R. Vol. III, Ex. 15, p. 18). The use of current was relatively small because the supply was inadeqquate, the service not dependable and the cost high (R. Vol. III, Ex. 15, pp. 20-21).

Here, then, was a rich territory, the development of which was being delayed by an inadequate supply of the cheap power which could be made available through proper financing of adequate electric generating and long distance transmission facilities. It is implicit in the record and cannot be questioned that the gathering together, integrating and financing of electric power facilities of the character described was at that time the chief business of American.

The risks involved were great. Failure to secure the individual projects necessary to develop an economical integrated system meant a huge loss on investments made. Success in assembling the required projects under a single control, however, insured proper development and automatically tremendously increased the value of the combined properties. Thus, from a realistic point of view, the total of the "original cost" of each separate project was of little significance in determining the value of the assembled whole which was transferred to Pacific.

American after investigation of the opportunities and risks involved, early in 1910 and in some instances prior

thereto, not only began acquiring the units composing the four systems referred to, but also started negotiations and made initial investments in Priest Rapids, where it envisioned a hydro-electric development comparable to the present Bonneville project (R. 182-5). The plan in broad outline contemplated the improvement of the existing hydro generating facilities sufficiently to supply the combined systems, when properly integrated through transmission lines, until such time as the demand for power could be built up to justify the financing of the prospective project at Priest Rapids. The demand, however, never became sufficiently pressing to make economically feasible the completion of the Priest Rapids development prior to the projection of the Government's plans for developing the Bonneville and Grand Coulee power sites, although expenditures actually made in promoting Priest Rapids to date amount to approximately $4,000,000, without accumulated interest thereon (R. 185).

The development, unification and integration, to the extent feasible, of the systems and the improvement of the generating facilities, mainly through development of the hydro-electric sites, were carried out according to plan. By December 31, 1936 the generating capacity of the system had been increased from 11,875 kw. to 30,567 kw., the miles of pole lines for transmission and distribution from 388 to 3,748, the number of electric consumers from 7,356 to 57,439 (not including customers connected with the properties leased to Northwestern Electric Company), and, the gross annual electric earnings from $592,781 to $4,394,429 (excluding revenues from properties leased to Northwestern Electric Company) (R. Vol. III, Ex. 15, p. 18). The rates for residential service in Yakima, Washington, for example, had been reduced from $2.25 for 15 kw. hours prior to July 1, 1910 to $1. for 15 kw. hours on March 1, 1939 and from $30.25 for 250 kw. hours prior to July 1, 1910 to $7.10 for 250 kw. hours on March 1, 1939. In general these rate reductions are typical of the rate decreases in all communities served by

Pacific (R. Vol. III, Ex. 15, p. 21). Generally speaking, the average annual consumption of electricity per customer has likewise risen from less than 500 kw. hours to approximately 2500 kw. hours, which is almost double the national average (R. Vol. III, Ex. 15, p. 20).

These facts significantly demonstrate the accuracy with which the directors of both American and Pacific appraised the value of the businesses and properties which were transferred to Pacific in July of 1910 as the nucleus for the great integrated power system which now occupies the territory served by Pacific.

Although the complete integration of the whole Columbia River District through the development of Priest Rapids, as contemplated by American has been interrupted by the activities of the Federal Government in the district (R. 184), the success of the Pacific project following the common ownership and integration of the individual projects is the best possible proof of the inherent values present in the business and properties under a common ownership.

(e) Nature of Proceeding before Commission

The Commission, by its order Number 42, adopted June 16, 1936, as amended, prescribed its "Uniform System of Accounts" for public utilities and licensees. Said System of Accounts, as supplemented by the Commission's order of May 11, 1937, directed (by Electric Plant Accounts Instruction 2-D) all public utilities, including Pacific, to reclassify their electric plant accounts, and to submit to the Commission certain statements showing pro forma reclassifications of their electric plant accounts in accordance with the provisions of said System of Accounts.

Said System of Accounts, and the reclassification of accounts so directed by said Instruction 2-D and by the Commission's said order of May 11, 1937, provide for showing cost of utility plant or property upon the so-called "original cost" basis, such "original cost" being defined in said System of Accounts as "the cost of such property to the person first devoting it to public service." Pacific's ac-

counts at all times have accurately recorded such "original cost" of all property constructed or first applied by it to public service. As has been stated, a large part of Pacific's utility property was not constructed or first so applied by it, but was purchased by Pacific, along with other properties, as assembled local operating enterprises, from prior owners thereof (there were 145 such prior owners—see R. Vol. III, Exhibit 15, pp. 1-115); and, in the majority of cases, the books and records of such prior owners with respect to such property were either not available to Pacific, or, if available in whole or in part, were not adequate or acceptable records of such "original cost".

After certain preliminary proceedings before the Commission, followed by the filing by Pacific on July 3, 1940, of a tentative reclassification of its electric plant accounts in response to said order of May 11, 1937, and later by the filing with the Commission of a so-called "joint report" by the staffs of the Commission and the Public Utilities Commissioner of Oregon (R. Vol. III, Ex. 16), the Commission entered an order on July 1, 1941, requiring Pacific, among other things, to show cause why Pacific should not make the accounting adjustments proposed in such joint report, and further requiring Pacific to submit appropriate plans for the "disposition" of such amounts as might be established in so-called "Account 100.5, Electric Plant Acquisition Adjustments", and so-called "Account 107, Electric Plant Adjustments" (R. 1-5).

On September 26, 1941, Pacific completed and delivered to the Commission copies of its revised reclassification of its electric plant accounts, and of its further and revised original cost studies upon which said revised reclassification was based; and such revised reclassification statements and original cost studies (R. Vol. III, Ex. 17), together with said joint report of the staffs of the Commission and the Oregon Commissioner, were presented at the hearing held by the Commission at Portland, Oregon, from September 29, 1941 to October 8, 1941.

In the course of this hearing or shortly thereafter, all disputes between the Commission's accounting staff and Pa-

cific as to the correct figures or amounts of specific items were reconciled, and any prior differences were eliminated; and, prior to December 31, 1942, full agreement was reached with respect to the accounting treatment of all items under consideration, except only as to the treatment to be given to the items and amounts specified in Paragraphs (A), (B) and (H) of the Order of November 24, 1942. Appropriate accounting entries reflecting such agreement were made in Pacific's books, some late in 1941, and others in 1942 after Pacific's receipt of copy of the Order (R. 83-89). The entry required by Paragraph (A) of the Order was made in July of 1943, after Pacific concluded to withdraw its objections to said Paragraph (A).

At the hearing petitioners offered to prove that the reconstruction cost new, less accrued depreciation, of the properties of Pacific as of December 31, 1940, the last year-end prior to the hearing, was $34,750,000 including $3,000,000 of going concern value, and that at the time of the hearing such reconstruction cost new, less depreciation, of the properties of Pacific was not lower, but, if anything, higher than on December 31, 1940. The Commission, however, refused to admit this evidence on the ground that "the fair value * * * has no bearing at all in the proceeding" (R. 202-208).

Paragraph (B) of the Order directs Pacific to "dispose of" the amount of $4,121,981.41, now classified in Account 107 in compliance with said Paragraph (A). As stated in effect in the Commission's "Opinion No. 84" (R. 41), it is not disputed that the assets transferred by American to Pacific in 1910, 1915, and 1930 (p. 5 *supra*), cost Pacific in par or principal amount of its securities, this amount of $4,121,981.41 in excess of their actual cash cost to American, excluding from consideration the approximately $4,000,000 of cost which American incurred upon the proposed Priest Rapids power development on the Columbia River, in furtherance and for the benefit of the enterprise transferred by it to Pacific in 1910 (R. 182-185). What Petitioners do dispute, and what they emphatically deny, is the existence of any right or authority in the Commission to require Pa-

cific to "dispose of" this $4,121,981.41 in the manner directed by said Paragraph (B), or in any other manner, so long as the acquired assembled enterprise in connection with which this cost was incurred remains the property of Pacific, and so long as the fair value of the properties employed therein is equal to or greater than this amount, plus the amount of the so-called "system cost" or cost to American thereof.

Paragraph (H) of the Order directs Pacific also to "dispose of" the amount of $2,741,591.66, now classified in Account 100.5, Electric Plant Acquisition Adjustments. This $2,741,591.66 represents the excess over so-called "original cost" of the cost to Pacific or to American of properties and assets acquired in transactions with former owners who were in no way affiliated or associated with either Pacific or American. There is no dispute as to either the amount or the origin of this item. As stated by Mr. Van Scoyoc of the Commission's staff in referring to this amount—

> "I am dealing there with items which were bonafide payments in arms-length transactions above original cost * * * as amounts legitimately invested in the business" (R. 504).

Again, what Petitioners do dispute, and what they emphatically deny, is the existence of any right or authority in the Commission to require Pacific to "dispose of" this $2,741,591.66 "legitimately invested in the business", so long as the investment made at this cost remains the property of Pacific, and so long as the fair value of the assets, in the acquisition of which this "arm's length" cost was incurred, is equal to or greater than this amount, plus the so-called "original cost" of such assets.

Questions Involved

The questions presented by this review are:

I. Although the petitioner, Pacific, as above indicated, has voluntarily made certain entries suggested by

the Commission on its fundamental books of account, the question arises as to whether or not said petitioner must involuntarily make the disposition here ordered of the items recorded in Account Nos. 100.5 and 107 and record the same in its fundamental books of account rather than merely in a separate system of memorandum accounts for the information of the Commission, in view of the opinion of this Court dated February 13, 1942 in the case of *Northwestern Electric Co.* v. *Federal Power Comm.,* 125 F. (2d) 882, which stated:

> "Petitioner may keep such other accounts as it desires. The present regulation only requires a particular system of accounts to be kept, not that other systems shall not be kept."

(However, compare the decision of this Court in *Northwestern Electric Electric Co.* v. *Federal Power Commission,* 134 F. (2d) 740, which cannot be given effect unless the order be deemed to govern the company's fundamental books of account.)

II. Has the Commission authority, by a retroactive application of its rules, which ignores all questions of value, of legality and of cost entering into a transaction at the time of its occurrence and according to the jurisdiction to which it was then subject, to require the elimination from public utility accounts of asset items lawfully established in such accounts long prior to the time the Commission was granted any authority with respect to such accounts?

III. Has the Commission authority to require Pacific to "dispose of" any amount now recorded in its asset accounts (in either Account 100.5 or Account 107), without proof that any part of the related asset values have been lost, when Pacific's asset accounts are fully supported by the present fair value of Pacific's assets, even though in excess of the Commission's determination of "original cost" as defined by it?

IV. Has the Commission acted lawfully, in refusing to permit the introduction of or to consider competent and properly proffered evidence on the issue of "disposition", which fully establishes that the fair value of Pacific's assets is equal to or greater than the recorded book value of such assets?

V. Has the Commission authority to require Pacific to dispose of the amount of $2,741,591.66 in Account 100.5, Electric Plant Acquisition Adjustments, by annual charges to income or otherwise, when said amount represents admitted actual cost and investment in utility assets, incurred in arm's length transactions between non-affiliated parties, so long as the assets purchased at such cost remain the property of Pacific?

VI. Has the Commission authority to deprive Pacific of the right to declare and pay, and its stockholders, preferred and common, of the right to receive, dividends lawfully earned upon Pacific's preferred and common stocks, to the extent that the "disposition" of the amount of $2,741,591.66 in Pacific's Account 100.5, at the rate of $274,159.17 per year for ten years, will necessarily divert lawful earnings and render them unavailable for the declaration and payment of such dividends and to the extent that the ordered "disposition" of the $4,121,981.41 will diminish or wipe out Pacific's surplus, which is fully supported by the fair value of its assets, and presently available for dividends?

VII. Has the Commission authority to require Pacific so to readjust its books and accounts as to record its assets on such books and accounts at less than their actual cost and their present fair value?

VIII. Is Section 301 (a) of the Act (16 U. S. C. A. § 825(a), if construed as authorizing the Commission to order Pacific to "dispose of" the amount of $4,121,981.41 in Account 107, and the further amount of

$2,741,591.66 in Account 100.5, as provided by Paragraphs (B) and (H) of the Order, a valid and constitutional enactment; or does the section as so construed violate the due process clause of Article V of the Amendments to the Constitution of the United States, or contravene Articles IX and X of said Amendments, or assume to confer judicial powers upon the Commission in violation of Article III of said Constitution?

Specification of Errors

(1) The Commission erred, as to Paragraph (B), in ordering Pacific to "dispose of" said amount of $4,121,981.41 of acquisition cost reclassified in Account 107 for the reason that the Commission has no authority under the Act, or under the Constitution of the United States, to require the elimination from the asset side of the balance sheet of a public utility of any sum fully supported by the present fair value of its assets, even though in excess of the Commission's determination of "original" or other cost.

(2) The Commission erred, as to said Paragraph (B), in assuming that its authority under the Act extends retroactively to the elimination from the accounts of a public utility of asset items lawfully established in the accounts of such public utility long prior to the time when the Commission was granted any authority with respect to the accounts of such utility.

(3) The Commission erred, as to said Paragraph (B), in ignoring, and in refusing to permit the introduction of, competent, relevant, and properly proffered evidence on the issue of disposition, which fully establishes that the fair value of Pacific's assets is equal to or in excess of the recorded book value thereof, and in sustaining Respondent's objection that such evidence is "immaterial and irrelevant" (R. 203).

(4) The Commission erred, as to said Paragraph (B), and violated the vested property and constitutional rights

of Pacific and its stockholders, preferred and common, by directing in effect the elimination in whole or in part of Pacific's Earned Surplus created from lawfully earned income, the effect of which elimination would be to prevent the declaration or payment of dividends lawfully earned upon the capital stock of Pacific, and without regard or consideration for the value of Pacific's assets at the time of such elimination.

(5) The Commission erred, as to Paragraph (H), for the reasons hereinabove set forth under paragraphs (1), (2), (3), and (4).

(6) The Commission erred, as to said Paragraph (H), because the $2,741,591.66 in Pacific's Account 100.5 ordered by the Commission to be disposed of by amortization in ten equal annual charges to or deductions from income, represents admitted actual cost of and investment in Pacific's present assets, whether or not such assets be characterized as "intangible" assets; and said $2,741,591.66 of admitted actual cost and investment may not lawfully be required to be "written off" or disposed of, so long as the assets purchased at such cost remain the property of Pacific.

(7) The Commission erred, as to said Paragraph (H), because to require such amortization of said $2,741,591.66 of admitted actual cost and investment in Pacific's assets, would unlawfully and unconstitutionally deprive Pacific of the right to declare and pay, and its stockholders, preferred and common, of the right to receive, dividends lawfully earned upon Pacific's preferred and common stocks, to the extent that such amortization at the rate of $274,159.17 per year for ten years, beginning with the year 1942, will necessarily divert such lawful earnings to such other arbitrarily and unlawfully prescribed purpose. Even if it were conceded that the Commission has authority to require amortization of such amount, nevertheless the Commission erred in ordering such amortization through Account 537 rather than Account 505.

(8) The Commission erred, as to said Paragraphs (B) and (H), because the Commission, in issuing such orders, has exceeded the scope of its regulatory authority over Pacific under the Act, has contravened the Fifth and Tenth Amendments of the Constitution, and Sections 1 and 2 of Article III of the Constitution, and has infringed upon the regulatory authority reserved to the States by said Act and the Tenth Amendment to the Constitution.

(9) The Commission erred, as to said Paragraphs (B) and (H), by requiring Pacific to record its assets on its books at less than their present fair value.

(10) The Commission erred, as to Paragraphs (B) and (H), in failing to find that the amounts on the books of Pacific are fully covered and represented by assets having a value in excess of such amounts, and the Commission further erred in ordering the disposition of any part of the difference between original cost and the cost recorded on the books of Pacific, as required by Paragraphs (B) and (H) of said Order, because such failure to find and such portions of its Order are arbitrary and capricious, violate the Fifth and Tenth Amendments to the Constitution, constitute the taking of property for a public purpose without payment of just compensation, are contrary to the provisions of Sections 1 and 2 of Article III of the Constitution, and violate the constitutional guarantees of due process and of the judicial determination of fundamental questions of fact and law.

Summary of Argument

This Court, in the case of *Northwestern Electric Company* v. *Federal Power Commission,* 125 F. (2d) 882, held that the Commission's system of accounts is one that a reasonable man could believe was warranted, because "original cost", "while it is not the only factor" in the fixing of rates, is a "factor to be considered". Having reached that conclusion on the premise stated, and the further premise that the system provides a means to "show correctly one of

the factors in fixing rates'', the Court held that ''the judicial function is exhausted'' so far as concerns the validity of the Commission's system of accounts. In so holding, the Court also declared,

> ''Petitioner has as much property as it has ever had. The system of accounts takes nothing from petitioner'' (*id.* pp. 886-7).

As stated on page 2 *supra,* Petitioners have withdrawn their objections on this review to Paragraph (A) of the Order, Petitioner assuming the validity of the Court's declaration that the attachment of special labels to particular items in Pacific's accounts, in order to differentiate such items from ''original cost'', of itself ''takes nothing from petitioner''. The Commission's Order, however, now seeks to employ such *labels* as devices to compel Pacific to make further entries in its books, which would state in effect—''Pacific has $4,121,981.41 less property than it previously had, and its property will diminish at the further rate of $274,149.17 each year for the next ten years''—solely because of the issuance of this Order. No realistic person may contend that such Order ''takes nothing'' from petitioner, or even that ''petitioner has as much property as it has ever had'', assuming the term ''property'' includes the rights which normally flow from corporate ownership of tangible and intangible assets.

If Pacific has as much property as it ever had, there can be no basis, in law or in morals, for the Commission's requiring Pacific to ''dispose of'' the items referred to in Paragraphs (B) and (H), by making entries in its books*

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*It is assumed in view of the phraseology of the Commission's Order (R. 61-4) and in view of the provisions of the order staying proceedings pending determination of this review (R. 110-12), that the Commission deems it's Order to be applicable to the fundamental books of account of Pacific. The arguments made in this brief are therefore based upon that assumption. However petitioners believe that the same arguments would apply, with perhaps some difference of degree and effect and from a somewhat different point of view, if the order is deemed to apply only to a set of memorandum accounts for the information of the Commission. Petitioners therefore respectfully reserve the right to argue the applicability of the contentions made herein if the position of the Commission is clarified to show that the entries directed in the Commission's Order are required to be made only on a memorandum set of books for the information of the Commission.

and published balance sheets showing that Pacific's assets have been reduced by $6,863,573.07, as compared with the situation before the Order was issued, unless the Commission had the power to determine, and had lawfully determined, that such amount of assets was non-existent or had disappeared. The Commission made no such determination, and rejected, as irrelevant on the "disposition" issue, all evidence proffered by Petitioners to demonstrate the existence of assets to cover the full amount of the items so to be disposed of, plus all other amounts recorded in its asset accounts.

Thus, the Commission goes beyond the function of prescribing accounting *labels,* and assumes the further authority to "dispose of" costs and values lawfully recorded on Pacific's books of account (in 1910 and 1930), many years prior to the granting of accounting jurisdiction to the Commission (1935). In so doing, the Commission assumes authority not purported to be vested in it by the Act, and authority which the Act could not lawfully vest in the Commission, because any attempt so to do would violate the Fifth and Tenth Amendments, as well as Article III, of the Constitution of the United States.

ARGUMENT

POINT I

In ordering the disposition of the $2,741,591.66 classified in Account 100.5, Electric Plant Acquisition Adjustments, by charging the same against income in ten equal annual charges, the Commission is violating the constitutional rights of the Petitioners.

The Commission in Paragraph (H) of its Order of November 24, 1942, has directed that Pacific dispose of the amount of $2,741,591.66 classified in Account 100.5, Electric Plant Acquisition Adjustments, by charging said amount to Account 537, Miscellaneous Amortization, in ten equal annual charges, commencing with the calendar year 1942. This item of $2,741,591.66 represents the difference between the original cost of Pacific's utilities properties

to the person first devoting them to public service and the amount paid for those properties when they were first purchased either by Pacific or by American prior to their transfer by American to Pacific. There is no question but that the amounts paid for these properties were bona fide payments in arm's length transactions above original cost (R. 504). The Commission does not challenge these amounts as legitimate items of cost to the accounting utility.*

The position of the Commission and its staff members, however, is that substantially all of this excess above original cost represents payments for "intangibles", and that the cost of "intangibles" should not be permitted to remain on the books (R. 49, 495-6, 530-3), although it is conceded that the sum represents bona fide payments made in arm's length transactions; that it was legitimately invested in the business; that it represented legitimate expenditures chargeable to plant account at the time they were made and that a portion thereof is applicable to physical values (R. 492-3, 504, 512).

The sole basis for the Commission's order of amortization of this sum rests upon the opinion of two of its staff members to the effiect that this sum represents an intangible item which has no permanent place in the accounts of a public utility because, first, intangibles *tend to disappear* and under proper accounting treatment should be written off and, second, intangibles have no value for rate-making or security purposes.

(a)

The opinion testimony of the Commission's staff experts, as to the disappearing nature of the $2,741,591.66 and the need for its amortization, is not supported by the facts in the record or by sound accounting principles.

In the opinion of the members of the Commission's staff any sum in excess of "original cost" must repre-

* The question of disposition presented here, therefore, is altogether different from the question before this Court in *Northwestern Electric Co.* v. *Federal Power Commission*, 134 F. (2d) 740, where it was decided that the Commission properly ordered the amortization of an item of $3,500,000 found by the Commission to be a mere "writeup."

sent an intangible consisting of good will, going value, franchise value, monopoly value, nuisance value, etc., which are rooted in prospective earning power and merge and blend into one when considering the utility business (R. 530-1). To compare the values inherent in the difference between "original cost" and the amount paid by American for the various projects turned over to Pacific in 1910 as a unified whole with such intangible values as patents, franchises, etc., having a limited life, is an unfair attempt to disparage the incremental values which arose through the acquisition in a common ownership of the various projects, and which were inherent in the location of the projects and businesses, subject only to their unification and integration. Such difference in cost is actually represented by the tangible properties so acquired and as they are now integrated and in operation. Regardless of whether or not the different types of intangibles listed by members of the Commission's staff tend to merge into one intangible, there can be no question that the so-called intangible, here under consideration, has become inseparably merged into the tangible values of the projects assembled by American and transferred to Pacific. Intangibles of this nature cannot disappear because they were and are rooted in the potentialities and possibilities of the businesses and properties which constituted the assembled system, unified and developed to meet the needs and desires for electric energy in a service area favorably located in respect to both the potential needs of the territory and the available means for producing such electric energy by water power.

The value of such intangibles increases rather than diminishes so long as electric energy continues to perform its peculiar function better than any other type of energy and the business of generating and distributing such energy continues to be successful. The so-called intangible values inherent in this business, conducted in a rapidly growing agricultural and industrial territory, cannot disappear. Certainly in such a territory and under the circumstances here prevailing it would be preposterous

to assume, for instance, that the peculiar physical advantages inherent in Pacific's water power sites will disappear so long as the force of gravity continues to constitute one of the great cheap sources of energy and so long as the demand for the energy so produced continues to exist.

Such values do not disappear—they merely lose their identity by fusion with the system and situation of which they have become inseparable parts. They are not "intangibles" which tend to disappear, in the sense of depreciating or losing their value, except as the tangible values of which they are an integral part depreciate.

The clear distinction, from the standpoint of depreciation, between such items of value and intangibles having specific and limited lives such as patents, copyrights, and term franchises, is recognized and applied in the federal income tax law and regulations.

The United States Treasury Regulations provide:

> "Reg. 103, Sec. 19.23 (l)—3. *Depreciation of intangible property.* —Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. No deduction for depreciation, including obsolescence, is allowable in respect of good will."

To illustrate further, "organization expense" normally does not buy any items of physical equipment and is therefore classed as an intangible, yet, except in cases where the corporation has a specifically limited life by its charter, such expenses are not subject to amortization or

depreciation for income tax purposes. (*Logan-Gregg Hardware Co.*, 2 B. T. A. 647; *First National Bank of St. Louis*, 3 B. T. A. 807; *Emerson Electric Manufacturing Co.*, 3 B. T. A. 932; *American Colortype Co.*, 10 B. T. A. 1276. To the same effect, see *Simmons Co.* v. *Commissioner*, 33 F. (2d) 75; *Corning Glass Works* v. *Lucas*, 37 F. (2d) 798; and *International Textbook Co.* v. *U. S.*, 44 F. (2d) 254.)

The accounting authorities cited by the Commission in its opinion to bolster the opinion testimony of its experts (R. 50) afford no basis for the Commission's action. The Commission quotes from "A Statement of Accounting Principles" (1938), Sanders, Hatfield and Moore (published by American Institute of Accountants), the following paragraph:

> "The writing off of such intangible assets as good will evokes scarcely any protest, even when it is recognized that substantial good will exists. The general distrust of good will and the knowledge that it has been widely used to capitalize exaggerated expectations of future earnings leave an almost universal feeling that the balance sheet looks stronger without it. When actual consideration has been paid for good will, it should appear on the company's balance sheet long enough to create a record of the fact in the history of the company as presented in a series of its annual reports. After that, nobody seems to regret its disappearance when accomplished by methods which fully disclose the circumstances."

A careful reading of the quotation indicates that the authors are *excusing* the write-off of intangibles as a permissible exception to strict accounting principles in the interest of conservatism and in order to produce a balance sheet which "looks stronger". It should be noted that the authors insist that intangibles should in no event be written off until they have appeared long enough to create a record of the fact that they have been purchased and that thereafter they may be written off only if there is full disclosure of the circumstances.

That the writing off of amounts paid for intangibles is a principle of conservatism rather than accounting is further evident from the following language from the aforementioned "A Statement of Accounting Principles" (p. 12) which introduces the portion quoted by Commission counsel:

> "There is a prevalent impression that, while overstatement of assets or earnings is a major fault, understatement is less objectionable, and may be a positive virtue. It will be agreed at once that deliberate misstatement in either direction is not to be condoned; but when as frequently occurs, the demand is made for 'accurate statement,' the subject may not be thus simply dismissed. 'Accurate statement' in a literal sense is not possible; reasonable judgment must enter into many of the items shown in the statements. In most of the cases where understatement is alleged, the makers of the statements assert that they reflect the more essential truth, and that the difference is solely in the point of view. It is therefore proper to inquire into the circumstances which have led to any bias which may exist in favor of understatement, to observe the principal forms which understatement is apt to take, and to appraise the consequences of each.
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> * * * * * * *
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> "The common belief that less mischief is done by understatement than by overstatement is, in the hands of honest men, probably true; but with dishonest men understatement may serve their turn as well as overstatement."

Furthermore on pages 68 and 69 of the same work, the authors discuss the writing off of intangibles at some length as follows:

> "There is marked difference of opinion and practice as to whether or not goodwill should be written off, and if so, by what steps. *It is clear that goodwill itself suffers no actual decline as long as the earning power of the company remains unimpaired,* but the pervasive feeling that the showing of goodwill does not add to the strength of the balance-sheet has led to much writing off, usually in a few large amounts

rather than by systematic amortization. As a result, a considerable number of important companies now show goodwill at $1, and others at no value. Distrust of the goodwill item, so far as it exists, probably arose more from excessive valuations in the past than from question as to the reality of the item. A smaller number of companies show goodwill reduced by a reserve or allowance, but still at substantial amounts.

"To summarize:

"(1) Goodwill, like other assets, should be shown at its bona fide cost to the owner.

"(2) To attribute to goodwill an excessive value based on the par value of stock issued therefor or otherwise, is not good accounting.

"(3) *If there is no longer valuable goodwill, or if its value has been obviously impaired,* it should be written down. The resulting charge should be against capital or surplus, not against income.

"(4) The regular amortization of goodwill is *not considered imperative,* as is the amortization of wasting assets. Such a treatment, however, is not considered objectionable. Strictly speaking, the amortization is a charge against income for the period during which the goodwill is supposedly effective, but the practice of charging capital or surplus instead of current income is approved by accountants." (Italics supplied.)

From the above quotations, it appears that Commission counsel are leaning on a slender reed when they rely on principles of accounting as requiring the write-off of intangibles.

To hold as the Commission does (R. 49), that this sum of "$2,741,591.66 represents payment for intangibles" which "have questionable continuing value" and should be rapidly amortized, when the total tangible assets of Pacific into which the values represented by this sum have become inseparably merged, are conservatively valued in dollars greatly in excess of this sum plus the "original cost" of such assets, is to permit the glib but unsupported

opinion of the staff's experts to prevail over fact and common sense. The testimony of the Commission's witnesses ignores the reality of intangible values—values which are present in every successful enterprise and, where related to the integration of utility properties, to the efficiency of the system thus created and to the economy of its operations, are inseparable from the physical property and its use.

For the Commission to require that asset values, representing admitted legitimate cost, be written off the books of Pacific on the basis of mere opinion testimony that good accounting requires such disposition (R. 531), which is unsupported by accounting authorities and contradicted by the affirmative evidence of present value proffered by Pacific, is to deprive Pacific and American of property without due process of law, in violation of the rights guaranteed by Article V of the Amendments to the United States Constitution. Congress certainly could not within its constitutional powers pass a valid act requiring that all intangible values recorded on the books of every public utility under its jurisdiction must be written off without consideration of any evidence as to the disappearance of their value. The Commission certainly has no greater power than Congress.

(b)

The opinion testimony of the Commission's staff experts as to the impropriety of including the $2,741,591.66 in the rate base is not supported by any factual evidence or any accounting or legal principle applicable to the issues here involved.

Despite the tangible nature of the value under consideration, due to its inextricable merger into the tangible assets purchased, both the Commission and its staff members further argue that it should be eliminated from Pacific's accounts because it "may have no value whatever for the purposes of rate making or for security purposes" (R. 531-532). Although this sum of $2,741,591.66 is recognized as a legitimate investment (a legitimate cost to Pacific as defined in the System of Accounts) and although the record is

barren of any evidence that the value inherent therein has disappeared, (the evidence being merely that intangible values *tend to disappear*), the Commission has ordered it amortized in ten equal installments through Account 537, thereby making it a charge against net income rather than a charge against operating expense to be absorbed by the rate payer for which provision is specifically made in Account 505 (R. 512-514). This treatment of the item was ordered by the Commission on the thesis of one of its staff members to the effect that the item should not be absorbed by the rate payer, though it be conceded that the item represents a legitimate investment (cost) to Pacific, that it is fully covered by the fair value of its tangible property and that it might receive a different treatment in a rate case before another agency (R. 508-511), simply because in his opinion it should not be considered in the rate base (R. 515).

That it would receive a different treatment by the Supreme Courts of Oregon and Washington, which states have jurisdiction over Pacific's rate base, is evident from the following decisions:

> *Pacific Telephone & Telegraph Co.* v. *Wallace,* 158 Ore. 210, 75 Pac. (2d) 942 at p. 950;
> *State* v. *Department of Public Works of Washington,* 184 Wash. 451, 51 Pac. (2d) 610.

It may be that a separate allowance for intangibles or going concern value need not be made in establishing a rate base, but neither the Act nor the Commission's account regulations can constitutionally require the elimination from the rate base of amounts paid for property in excess of original cost where such items are supported by the present fair value of the property assembled as a whole.

> *Smythe* v. *Ames,* 169 U. S. 466;
> *Driscoll* v. *Edison Co.,* 307 U. S. 104;
> *Fed. Power Comm.* v. *Nat. Gas Pipeline Co.,* 315 U. S. 575.

It is significant that the Commission either regards rate determination with respect to Pacific as within its province or else regards its system of accounts as the exclusive sys-

tem of accounts to be kept by Pacific for all purposes, including state regulation of rates. Clearly the Commission has no rate making jurisdiction over Pacific, for all of its rates are subject to regulation by the State of Washington or the State of Oregon. Section 201(a) of the Act (16 U. S. C. A. § 824(a)) expressly limits the jurisdiction of the Commission to "those matters which are not subject to regulation by the States". Furthermore rate making is an evaluation function requiring the exercise of judgment and is vested in management and in government commissions only when they are specifically granted such jurisdiction—never in accountants. Rates are never determined solely through the agency of an accounting system.

However, if it is desirable that the values established in accounts and in the rate base be brought more closely together, the Commission may not order the elimination from the accounts by amortization or otherwise of existing values which have neither disappeared or been lost. Neither may it use the pretext of segregating and pocketing individual items of physical assets according to its own peculiar definition of cost, without regard to existing aggregate values heretofore legally and properly recorded on the books, for the purpose of building up out of the residue a composite item to be arbitrarily labeled intangibles or write-up and disposed of on that basis, if the total asset value of the enterprise as a unit is sufficient to cover dollar for dollar the recorded book value of the enterprise. The patent illegality and impropriety of such procedure is pointed when, as here, the composite item represents conceded items of cost to Pacific recorded on its books as an investment many years before the passage of the Act. In short the Commission has "no power to compel a corporation to write off from its book value a loss which it has not sustained, or to give up a part of its constitutional rights."

> *New York Edison Co.* v. *Maltbie,* 244 App. Div. 685, aff'd, 271 N. Y. 103.

In other words the Commission may not, for accounting purposes, order the elimination of book values by

building up such a composite item on rate base principles without accepting all the fundamental principles applicable to the establishment of a rate base.. If items already on the books are to be eliminated on rate base principles rather than on principles of accounting, a consistent approach would require the full application of rate base principles to the problem and the consequent retention on the books of the company of all book values fully supported by the present value of its assets devoted to the public service.

Assuming that it is important and desirable that a system of accounts supply useful information for rate proceedings, *it is absolutely essential*, in order that the Act authorizing the establishment of such a system and the system itself may survive a charge of constitutional invalidity, (a) that the accounting corporation (Pacific in this case) be permitted to retain on its fundamental books of account all items of value which it is entitled to have considered under established principles of rate regulation, particularly with respect to matters recorded long before the effective date of the Act, and (b) that its fundamental books of account, if the Commission purports to exercise jurisdiction with respect thereto and not merely over a memorandum system of records for its own use and information, be permitted to serve other useful and essential purposes in the conduct of its business.

In the words of the Court in *N. Y. Edison Co.* v. *Maltbie*, 244 App. Div. 685, aff'd, 271 N. Y. 103,

> "* * * The books of a utility corporation are not kept solely for the information or benefit of the Commissioner; * * * stockholders, bond owners, the investing public and rate payers are interested; also * * * corporate financing is done upon the basis of book values (Norfolk & Western R. Co. v. U. S., 52 F. (2d) 967)."

It follows from this that the propriety of retaining items in the accounts of a utility or of writing them off is not governed solely by whether such items are proper components of the rate base. For example property owned by

a utility corporation which is not used or useful in the rendition of the public service is not included in the rate base. Yet clearly, such property, as long as it is owned by the utility, must appear as an asset on the utility's accounts.

While purporting to be interested only in establishing and administering an accounting system based on established accounting principles, the Commission is in reality ordering the elimination of this item by an improper and partial application of principles relating to the establishment of a rate base, which, for all practical purposes accomplishes a quasi-reorganization of Pacific without consideration of the fundamental standards of value applicable both to reorganizations and to the establishment of a rate base. As to reorganizations, see:

Consolidated Rock Products Co. v. *DuBois,* 312 U. S. 510, and cases there cited;
National Surety Co. v. *Coriell,* 289 U. S. 426, 436;
Finletter, The Law of Bankruptcy Reorganization (1939) 557-560;
Craven and Fuller, The 1935 Amendments of the Railroad Bankruptcy Law, 49 Harvard Law Review, 1254, 1272-1274;
Bonbright, Valuation of Property (1937) 884-893;
Dewing, The Financial Policy of Corporations (1941), Vol. II, pages 1373-1376;
In the Matter of Utilities Power & Light Corp., 5 SEC 483, 500-501.

As to rate base, see: *Smythe* v. *Ames* and other cases cited on p. 27, *supra.*

The illegality of the Order is emphasized by the illogical and inconsistent attitude of the Commission in eliminating the item on the basis that it has no *value* for regulatory purposes (R. 533-49), and by summarily approving the exclusion of the proffered evidence of value on the theory that "*cost not value* is the fundamental basis for accounting for public utility plant" (R. 47).

Hence, in so far as the Commission based its Order for the amortization of the $2,741,591.66 on the opinion of its staff experts as to the impropriety of the inclusion of that item in the rate base, without consideration of Petitioners' proffered proof of value, its order is grounded on inconsistent theories and is not supported by any substantial factual evidence or any accounting or legal principles relevant to the issues. To sustain such an order is to deprive the petitioners of the due process of law which they are guaranteed by the United States Constitution.

(c)

The writing off of asset items in excess of original cost, where fully supported by present fair value, has been properly condemned as unconstitutional by the courts.

While it is perhaps true, as was stated in *Northwestern Electric Company* v. *Federal Power Commission,* 125 Fed. (2d) 882 (C. C. A. 9th, 1942) at p. 886, that the petitioners are deprived of nothing by a mere segregation of asset items into original cost and amounts in excess thereof, both Pacific and American suffer a real detriment when by the arbitrary order of the Commission, earnings or suplus which would otherwise be available for the payment of dividends are used for the needless writing off of the cost of assets having a current existence and value.

The action of the Commission in thus ordering the disposition of the cost to Pacific of its assets in excess of the original cost of such assets to the person first devoting them to public service, without consideration of proffered evidence of the present value of such assets, is a clear violation of the rule laid down by the United States Supreme Court in *American Telephone & Telegraph Co.* v. *United States,* 299 U. S. 232 (1936).

There was under consideration in that case the validity of a system of accounts promulgated by the Federal Communications Commission, which contained a Plant Acquisition Adjustment Account similar to Account 100.5 in the system of accounts here under consideration. The Court

upheld the system only on the representation of the Federal Communications Commission that it was not the intention of the Commission in promulgating the system of accounts to require a mandatory or arbitrary write off of amounts classified in the Plant Acquisition Account. To the argument of the Telephone Company that sub-division (C) of the Acquisition Account there under consideration, providing that "the amounts recorded in this account with respect to each property acquisition shall be disposed of, written off, or provision shall be made for the amortization thereof in such manner as this Commission may direct," implied an arbitrary or mandatory write off, the Court replied:

> "If subdivision (C) had the meaning thus imputed to it, *there would be force in the contention that the effect of the order is to distort in an arbitrary fashion the value of the assets.* But the imputed meaning is not the true one. The Commission is not under a duty to write off the whole or any part of the balance in 100.4, *if the difference between original and present cost is a true increment of value.* On the contrary, only such amount will be written off as appears, upon an application for appropriate directions, to be a fictitious or paper increment. This is made clear, if it might otherwise be doubtful, by administrative construction. Thus, the Commission's chief-accountant testified that by the proper interpretation of Account 100.4, amounts therein 'would be disposed of, after the character of the item had been determined, in a manner consistent with the general rules underlying the uniform system of accounts for the distribution of expenditures, according to their character, to operating expenses, income, surplus, or *remain an investment.*' Other witnesses gave testimony in substance to the same effect. But even more decisive are statements made by counsel, appearing for the Government and arguing the case before us. To avoid the chance of misunderstanding and to give adequate assurance to the companies as to the practice to be followed, we requested the Assistant Attorney-General to reduce his statements in that regard to writing in behalf of the Commission. He did this and informs us that 'the Federal Communications Commission con-

strues the provisions of Telephone Division Order No. 7-C, issued June 19, 1935, pertaining to account 100.4' as meaning 'that amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent *an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired;* and, in accordance with paragraph (C) of account 100.4, provision will be made for their amortization.'

"We accept this declaration as an administrative construction binding upon the Commission in its future dealings with the companies. *Hicklin* v. *Coney,* 290 U. S. 169, 175; *Addy Co.* v. *U. S.,* 264 U. S. 239, 245. The case in that respect is sharply distinguished from *New York Edison Co.* v. *Maltbie,* 244 App. Div. 685, 281 N. Y. S. 223; id., 271 N. Y. 103, 2 N. E. (2d) 277, where under rules prescribed by the Public Service Commission of New York, there was an inflexible requirement that an account similar in some aspects to 100.4 be written off in its entirety out of surplus, whether the value there recorded was genuine or false. The administrative construction now affixed to the contested order devitalizes the objection that the difference between *present value* and *original cost* is withdrawn from recognition as a legitimate investment." (Emphasis added.)

It should be noted that the United States Supreme Court clearly lays down the rule that the writing off of assets which have a present value would be an objectionable infringement of the accounting utility's rights and that the difference between original and present cost shown on the company's books is not to be written off if it represents a "true increment" (i. e., a true increase) of value. The Court cites with approval the case of *New York Edison Co.* v. *Maltbie,* 244 App. Div. 685, aff'd, 271 N. Y. 103, which squarely held that a requirement of the Public Service Commission of New York that all amounts in excess of original cost be expunged from the books whether or not supported by present value, was an arbitrary exercise of power in violation of the utility's constitutional rights. The following language of the Court in the *New York Edison Co.* case is pertinent:

"* * * 'The power vested in the Commission to prescribe uniform methods of keeping accounts and records (Publ. Serv. Law, § 66, subd. 4) does not include the power to compel a corporation to write off from its book value a loss which it has not sustained, or to give up a part of its constitutional rights. If, as has been said, "the actual cost of the property—the investment the owners have made—is a relevant fact" (*Los Angeles Gas & Elec. Corp.* v. *Railroad Comm.,* 289 U. S. 287, 306), a corporation cannot be compelled to make entries upon its books calculated to conceal such relevant fact. It follows that the Commission had no power to impose such condition.' (*People ex rel. Iroquois Gas Corp.* v. *Public Service Commission,* 264 N. Y. 17, 21). The foregoing was written concerning a condition which the Commission sought to impose as to the purchase of the property of one utility corporation by another. If it lacks power as to one transaction, it also lacks power to enforce by a general rule such a condition as to all similar transactions.

"* * * It may desire information to enable it to proceed against corporations which it believes have inflated entries in their fixed capital accounts through intercompany transactions, and in connection therewith, information as to original cost to the predecessor utility corporation. *It could require that these facts be recorded in an account or memorandum disconnected from the fixed capital account, and thus avoid the unconstitutional requirement that losses which had not been suffered be shown on the books.* The petitioners argue, and with high judicial authority, that the books of a utility corporation are not kept solely for the information or benefit of the Commissioner; that stockholders, bond owners, the investing public and ratepayers are interested; also that corporate financing is done upon the basis of book values. (*Norfolk & Western R. Co.* v. *United States,* 52 F. (2d) 967). That to be required to show a loss on the books when none has been suffered is arbitrary. Many of the fixed capital accounts ordered to be redistributed contain entries reflecting purchases from predecessor utilities that were approved by the Commissioner and other entries concerning consolidation and purchases which have been approved by courts, including the Supreme Court of the United States. These entries are not made upon the basis of 'original cost' as the

> Commission now seeks to define it. Financing has been carried on and transactions made on the basis of these figures as to fixed capital. A requirement that a part now be charged off is confiscatory." (Emphasis supplied.)

It is therefore submitted that, on the authority of the foregoing court decisions, the Order of the Commission requiring the writing off of amounts actually expended by the accounting utilities in excess of original cost, on the mere speculation of Commission witnesses that such excess *may* represent intangible values which *may* have disappeared, and without consideration of the petitioners' proffered evidence of the present value of the assets, is unlawful and invalid in that it is arbitrary and capricious action depriving the petitioners of property without due process of law.

(d)

The recorded values on Pacific's books represent vested property rights which it is beyond the Commission's power to destroy by a retroactive application of its rules.

Long before the Federal Power Commission existed and long before original cost had become the fetish of regulatory commissions, American, in arm's-length transactions with completely unaffiliated interests, acquired the properties which it later transferred to Pacific. It paid the price mutually agreed upon by buyer and seller as the fair value of the individual properties. Admittedly, there was nothing improper about the transactions. The books of Pacific and the value of its properties have been the basis upon which Pacific's securities have been issued, its credit established and its dividends paid. Yet we now find the Commission many years later, requiring Pacific to write off its books all amounts in excess of the cost of the assets to the persons who first devoted them to public service. This is to be done, moreover, at the expense of American and the other security holders of Pacific by requiring the diversion of earnings which under corporate law and the contract between Pacific and its shareholders would be available for dividends.

The Commission neither has been nor could be granted the authority thus to destroy rights long since vested. The following language of the United States Supreme Court in *Osborn* v. *Nicholson,* 13 Wall. 654, pages 662-663, is pertinent:

> "But without considering at length the several assumptions of the proposition, it is a sufficient answer to say that when the thirteenth amendment to the Constitution of the United States was adopted, the rights of the plaintiff in this action had become legally and completely vested. Rights acquired by a deed, will, or contract of marriage, or other contract executed according to statutes subsequently repealed subsist afterwards, as they were before, in all respects as if the statutes were still in full force. *This is a principle of universal jurisprudence. It is necessary to the repose and welfare of all communities.* A different rule would shake the social fabric to its foundations and let in a flood tide of intolerable evils. It would be contrary to 'the general principles of law and reason,' and to one of the most vital ends of government. The doctrines of the repeal of statutes and the destruction of vested rights by implication, are alike unfavored in the law. Neither is to be admitted unless the implication is so clear as to be equivalent to an explicit declaration. Every doubt should be resolved against a construction so fraught with mischiefs. There is nothing in the language of the amendment which in the slightest degree warrants the inference that those who framed or those who adopted it intended that such should be its effect. It is wholly silent upon the subject. *The proposition, if carried out in this case, would, in effect, take away one man's property and give it to another.* And the deprivation would be 'without due process of law.' This is forbidden by the fundamental principles of the social compact, and is beyond the sphere of the legislative authority both of the states and the nation." (Emphasis supplied.)

This doctrine has been repeatedly enunciated by the Supreme Court. Although Congress, as an incident to

the exercise of its commerce powers, may impair contract rights, it may not confiscate property founded on contract rights vested at the time of the passage of an act purporting to grant such power, either for the benefit of the public or for one individual or group at the expense of another.

In *Lynch* v. *United States,* 292 U. S. 571, Mr. Justice Brandeis said, at page 579:

> "*Second.* The Fifth Amendment commands that property be not taken without making just compensation. Valid contracts are property, whether the obligor be a private individual, a municipality, a State or the United States. Rights against the United States arising out of a contract with it are protected by the Fifth Amendement. *United States* v. *Central Pacific R. Co.,* 118 U. S. 235, 238; *United States* v. *Northern Pacific Ry Co.,* 256 U. S. 51, 64, 67. When the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private individuals. That the contracts of war risk insurance were valid when made is not questioned. As Congress had the power to authorize the Bureau of War Risk Insurance to issue them, the due process clause prohibits the United States from annulling them, unless, indeed, the action taken falls within the federal police power or some other paramount power."

See also the case of *W. B. Worthen Co.* v. *Kavanaugh,* 295 U. S. 56, where Mr. Justice Cardozo held that even a procedural change which unreasonably postponed judicial remedies constituted a confiscation of property.

And see also the following cases which hold that an attempt to take away rights which are vested under a prior act, by the repeal thereof or by the provisions of a further statute, constitutes confiscation:

Coombes v. *Getz,* 285 U. S. 434;
Forbes Pioneer Boat Line v. *Board of Commissioners,* 258 U. S. 338;

Ettore v. *Tacoma,* 228 U. S. 148;
Pacific M. S. S. Co. v. *Joliffe,* 2 Wall. 450.

In the case of *Louisville Joint Stock Bank* v. *Radford,* 295 U. S. 555, Mr. Justice Brandeis, construing the so-called Frazier-Lemke Act of June 28, 1934, held that although that Act was adopted pursuant to the broad bankruptcy powers granted to Congress under the Constitution, the power therein granted must be exercised subject to the restrictions of the Fifth Amendment and that Congress may not take for the benefit of the debtor rights in specific property acquired by the creditor prior to the date of the Act, saying at pages 589 to 590; 597; 601 to 602:

> "*Fourth.* The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment. Under the bankruptcy power Congress may discharge the debtor's personal obligation, because, unlike the States, it is not prohibited from impairing the obligation of contracts. Compare *Mitchell* v. *Clark,* 110 U. S. 633, 643. But the effect of the Act here complained of is not the discharge of Radford's personal obligation. It is the taking of substantive rights in specific property acquired by the Bank prior to the Act.
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> * * * * * * *
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> "* * * Under the Act, the purpose of the delay in making a sale and of the prolonged possession accorded the mortgagor is to promote his interests at the expense of the mortgagee.
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> * * * * * * *
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> "* * * The province of the Court is limited to deciding whether the Frazier-Lemke Act as applied has taken from the Bank without compensation, and given to Radford, rights in specific property which are of substantial value. Compare *Ochoa* v. *Hernandez,* 230 U. S. 139, 161; *Loan Association* v. *Topeka,* 20 Wall. 655, 662, 664; *In re Dillard,* Fed. Case No. 3912, p. 706. As we conclude that the Act as applied has done so, we must hold it void. For the Fifth Amendment commands that, however great the Nation's need, private property shall not be

thus taken even for a wholly public use without just compensation. If the public interest requires, and permits, the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain; so that, through taxation, the burden of the relief afforded in the public interest may be borne by the public.''

(e)

The Commission's order requiring the amortization of the $2,741,591.66 is invalid because it is unauthorized by the Act and is a usurpation of the functions constitutionally reserved to the Judiciary and to the States.

The opinion and order of the Commission constitute, in effect, an adjudication that part of the common stock of Pacific is not legally paid up, since American is required to pay again for such common stock, through the diversion of earnings by charges to Account 537 for the amortization of the $2,741,591.66 recorded in Account 100.5 This is a holding that the Commission is authorized to assume exclusive jurisdiction of, and to oust judicial and other state authority over, internal affairs of a public utility company upon which the accounting requirements of the Commission or any order assumed to be related thereto may impinge.

But the Commission is not clothed with any such comprehensive, all-inclusive judicial and regulatory power. The Act expressly negatives such intent in language that must be deemed to have been carefully chosen and which was written into the bill after the hearings had disclosed great concern lest the Act interfere unduly with local regulation and its proponents had clearly stated that its purpose was to supplement state regulation and to fill the gap indicated by *Public Utilities Comm.* v. *Attleboro Steam & Electric Co.,* 273 U. S. 83. Section 201 (a) of the Act (16 U. S. C. A. § 824 (a), expressly provides that the Commission's regulatory authority shall *''extend only to those matters which are not subject to regulation by the States.''* The reports of the Senate and House Committees on Inter-

state Commerce on the bill and the statements of Commissioner Seavey, speaking as a member of the Commission, and Dozier DeVane, General Solicitor for the Commission, in support of this legislation make it evident that the bill was conceived entirely as a supplement to and not as a substitute for state regulation. The report of the Senate Committee contains the following illustrative statement:

> "Section 201—Subsection (a) contains a declaration of the necessity for Federal regulation and defines the scope of that regulation. * * * It also declares the policy of Congress to extend that regulation to those matters which cannot be regulated by the States and to assist the States in the exercise of their regulatory powers, but not to impair or diminish the powers of any State commission."

Certainly the provisions of Section 301(a) of the Act which purport to authorize the Commission to "determine by order the accounts in which particular outlays and receipts shall be entered, charged or credited," look to the future and not to the past (compare accounting procedure of Interstate Commerce Commission) and are not to be so construed as to make definitions and regulations issued in connection therewith determinative of legal rights regardless of consequences. Otherwise, the statutes of a state, and the decisions of its highest court interpreting the law of such a state, cannot be determinative and afford no assurance as to any contractual right or liability; all legal and equitable rules may be disregarded (in effect, discarded) and all *past* transactions, however *remote,* become subject to review and adjustment in accordance with what the Commission, in its own unfettered discretion, may consider desirable for the purposes of its future regulation. And "the security inherent in our judicial safeguards" may well be seriously impaired. *St. Joseph Stock Yards Co.* v. *U. S.* 298 U. S. 38, 52.

Any determination of whether Pacific is required to recognize its common stock as not fully paid is judicial in character. No provision is made for a judicial determination of this issue with its bearing on the payment of

dividends and as a result both the Act and the accounting regulations, if they be interpreted to give the Commission judicial authority to make such a determination, are void.

> *Crowell* v. *Benson,* 285 U. S. 22 at pp. 56 and 57;
> *St. Joseph Stock Yards Co.* v. *U. S.,* 298 U. S. 38 at p. 51;
> *Chicago, Milwaukee & St. P. Ry. Co.* v. *Minnesota,* 134 U. S. 418, 457, 458;
> *Ohio Valley Water Co.* v. *Ben Avon Borough,* 253 U. S. 287;
> *Bluefield Co.* v. *Public Service Commission,* 262 U. S. 679.

Pacific is a Maine corporation and the courts of that state alone have authority to determine the adequacy of the consideration received upon the issuance of capital stock of corporations organized under its laws or to enforce payment of an allegedly unpaid stock subscription.

> *Rogers* v. *Guaranty Trust Co. of N. Y.,* 288 U. S. 123;
> *Cohn* v. *Mishkoff Costello Co.,* 256 N. Y. 102;
> *Beasley* v. *Mutual Housing Co., Inc.,* 39 F. (2d) 290 (App. D. C.);
> *Wallace* v. *Motor Products Corp.,* 25 F. (2d) 655 (C. C. A. 6th).

The unauthorized character of the Commission's usurpation of judicial powers in this connection is emphasized by examination of the conflict which would arise in a converse situation. If the Commission is authorized to make such determinations without consideration of the law of the state of incorporation, it follows that the decree of a state court canceling stock which in its opinion had not been paid for could likewise be ignored by the Commission if the Commission's system of accounts may be administered without regard to the laws of the several states or to rights and obligations existing thereunder.

Petitioners submit that it was never intended that the Commission should have the authority which it is assert-

ing here. In any event the order of the Commission here under consideration, whether within the contemplation of the statute or not, is clearly invalid because it would take the property of these petitioners without due process of law and in violation of Article III of, and both the Fifth and Tenth Articles of the Amendments to, the Constitution of the United States.

The petitioners therefore submit that the order of the Commission requiring the amortization of the $2,741,591.66 classified in Account 100.5 should be declared invalid and beyond the authority of the Commission because (a) it is not based on substantial evidence, (b) the opinion testimony with respect to the propriety of including this item in the rate base is unfounded in law and fact and irrelevant to the issues, (c) it was entered without consideration of proffered evidence of present fair value, contrary to the rule established by the United States Supreme Court in the *American Telephone & Telegraph* case, (d) it is an unconstitutional destruction of rights long since vested, and (e) it is grounded on the assumption by the Commission of jurisdiction over matters reserved by the Constitution to the judiciary and to the states.

POINT II

In ordering the disposition of the $4,121,981.41 classified in Account 107, Electric Plant Adjustments, by writeoff to earned or capital surplus, the Commission is violating the constitutional rights of the Petitioners.

The Commission in Paragraph (B) of its Order has directed that Pacific dispose of the amount of $4,121,981.41 classified in Account 107, Electric Plant Adjustments, by charging $1,135,113.91 to a special surplus reserve previously established and the balance to earned surplus or a capital surplus properly created. This item of $4,121,981.41

represents the difference between the cost to Pacific and the cost to American of certain properties acquired by American from various nonaffiliated interests and sold to Pacific in 1910 and in 1930. This item has been classified by the Commission in Account 107 rather than Account 100.5, which purports to represent the difference between cost to the accounting utility and original cost, on the theory that this $4,121,981.41 was a mere "writeup" because it arose out of an intercompany transaction between parent and subsidiary. The Commission proceeds on the theory that cost under its System of Accounts means "system cost" rather than "company cost" where there are affiliated company relationships involved.

Petitioners are not quarreling with the Commission's giving this peculiar interpretation to the meaning of "cost" as applied to its system of accounts in so far as mere classification is concerned. It is for this reason that Pacific has withdrawn its objection to Paragraph (A) of the Commission's Order classifying this item in Account 107.

With respect to the disposition of this item, however, petitioners strongly insist that cost to American plus this adjustment item represents cost to Pacific insofar as Pacific's rights are concerned. The fact is, that as between Pacific and its security holders and American and its security holders, the total book value of the assets is the true corporate cost figure. The fact is that Pacific issued securities and stock for its assets to the full amount at which such assets are carried on its books. Cost is what is paid for a thing, irrespective of to whom it is paid. *Comm.* v. *Schumacher Wall Board Corp.*, 93 F.(2d) 79 (C. C. A. 9th, 1937.) Therefore the amounts at which Pacific's assets are carried on its books, while they do not represent, and do not purport to represent "system cost", do represent "company cost" and as such cannot be written off if shown to be supported by existing values for the reasons, already set forth in Point I above, which render

improper the Commission's order to amortize the \$2,741,591.66 in Account 100.5. The petitioners offered to prove existing values in the assets sufficient to cover every dollar of this cost to Pacific, but the Commission refused to consider such evidence, regarding it as irrelevant to the issues. In ordering the writeoff of the \$4,121,981.41 the Commission was clearly in error and its order is invalid under the rule of *American Telephone & Telegraph Co. v. United States,* 299 U. S. 232.

However, even if the amount recorded on Pacific's books to the extent in excess of American's cost, is not regarded as "cost" in any sense of the word, but is regarded as a mere "write-up" the same principles forbid the expunging of this amount from the books if supported by present value. As was stated in *Re Jersey Central Power & Light Co.,* 33 P. U. R. (N. S.) 207, 212:

> "* * * The identification of 'write-ups' in approximately this amount does not create, however, a supposition that the restatements of book cost were illegitimate, improper, or unreasonable at the time when made. In fact, the past recognition of appreciated values for accounting purposes is implied by the decision of the Supreme Court of New Jersey in Passaic Consol. Water Co. v. Public Utility Comrs. (1927) 5 N. J. Misc. R. 1078, P. U. R. 1928 B, 242, 139 Atl. 324 aff. [1928] 104 N. J. L. 666, 141 Atl. 921), to the effect that in 1925 a utility had the right to record on its books 'the full value of its property' * * *."

The reclassification of Pacific's accounts pursuant to the Commission's special system of accounts and the resulting inclusion of \$4,121,981.41 in Account 107, Electric Plant Adjustments, by no means involves an appropriate determination that the surplus recorded on Pacific's books and now required to be completely charged off is either non-existent or in any way impaired. *Randall v. Bailey, et al.,* 288 N. Y. 280. As Mr. Justice Brandeis said, in *Edwards v. Douglas,* 269 U. S. 204, at page 214:

> "The word 'surplus' is a term commonly employed in corporate finance and accounting to designate an

> account on corporate books. * * * The surplus account represents the net assets of a corporation in excess of all liabilities including its capital stock. This surplus may be 'paid-in surplus,' as where the stock is issued at a price above par. It may be 'earned surplus,' as where it was derived wholly from undistributed profits. Or it may, among other things, represent the increase in valuation of land or other assets made upon a revaluation of the company's fixed property. See *La Belle Iron Works* v. *United States*, 256 U. S. 377, 385."

Significant also in this connection is *Passaic Consolidated Water Company* v. *Board of Public Utility Commissioners,* 139 Atl. 324, affirmed 141 Atl. 921, in which the Supreme Court of New Jersey held that a utility had the right to record on its books "the full value of its property" and by clear implication approved the prior recognition of appreciated values for accounting purposes.

See also:

People ex rel. Iroquois Gas Corp. v. *Pub. Serv. Comm.,* 264 N. Y. 17, 189 N. E. 764;
Matter of New York Edison Co. v. *Maltbie,* 244 App. Div. 685, affirmed 271 N. Y. 103;
Matter of Lockport Light, Heat & Power Co. v. *Maltbie,* 257 App. Div. 11, 12 N. Y. S. (2d) 595.

Conclusion

It is therefore submitted that the Order of the Commission dated November 24, 1942, in so far as it directs the amortization or write-off of amounts classified in Account 100.5, Electric Plant Acquisition Adjustments, or Account 107, Electric Plant Adjustments, without any consideration of the present values supporting the total book value of Pacific's assets, is beyond the statutory

and constitutional authority of the Commission, and is invalid as an unconstitutional deprivation of petitioner's property without due process of law and an unconstitutional assumption by the Commission of jurisdiction reserved by the Constitution to the judiciary and to the several states. If deemed to authorize said Order, Section 301 (a) of the Act is unconstitutional and void.

Respectfully submitted,

John A. Laing,
Henry S. Gray,
Public Service Building,
Portland, Oregon.

Attorneys for Petitioner,
Pacific Power & Light Company.

A. J. G. Priest,
Two Rector Street,
New York, New York.

Adrian L. Foley,
14 Wall Street,
New York, New York.

Attorneys for Petitioner,
American Power & Light Company.

Laing, Gray & Smith,
Portland, Oregon.

Reid & Priest,
White & Case,
New York, New York.

of Counsel.